Warranties (ASC 460 & ASC 606)

1. 🔍 Warranty Overview

- **Definition**: A seller's promise to repair, replace, or refund defective products/services within a specified period.
- **Matching Principle**: Warranty costs are expensed in the same period as the related sale, even if actual costs are incurred later.
- **Relevant Standards**:
  - **ASC 460**: Accounting for guarantees (including warranties).
  - **ASC 606**: Revenue recognition; distinguishes between warranty types.

2. 🧭 Types of Warranties

Type	Description	Accounting Treatment	CMA Tip
Assurance-Type	Included in product price; ensures product meets specs	Not a separate performance obligation; accrue liability at sale	Focus of most CMA questions
Service-Type	Sold separately; provides extra coverage	Separate performance obligation; defer revenue and recognize over time	Look for customer payment triggers
Hybrid	Contains both elements	Allocate between assurance and service-type	Requires judgment and disclosure

3. 🪫 Accounting for Assurance-Type Warranties

Recognition Criteria:

- **Probable** and **Estimable** → Accrue at sale.

Estimation Basis:

- Historical data, engineering studies, industry benchmarks.

Formula:

Warranty Expense = Sales Revenue × Estimated Warranty Cost %

Journal Entries:

At Sale (Accrual):

plaintext

Dr. Warranty Expense

Cr. Warranty Liability

When Costs Are Incurred:

plaintext

Dr. Warranty Liability

Cr. Cash / Payables / Inventory

4. 📐 Examples by Warranty Type

✅ A. Assurance-Type Warranty

Scenario:

- Sales: $5,000,000
- Estimated Warranty Cost: 3%
- Expense = $150,000

Entry:

plaintext

Dr. Warranty Expense 150,000

Cr. Warranty Liability 150,000

🪫 B. Service-Type Warranty

Scenario:

- Laptop sold for $1,000
- Extended warranty sold separately for $200
- Expected cost: $120 over 2 years

At Sale:

plaintext

Dr. Cash 1,200

Cr. Sales Revenue 1,000

Cr. Unearned Warranty Revenue 200

Year 1 Revenue Recognition:

plaintext

Dr. Unearned Warranty Revenue 100

Cr. Warranty Revenue 100

When Costs Incurred:

plaintext

Dr. Warranty Expense 60

Cr. Cash / Payables 60

⚖️ C. Hybrid Warranty

Scenario:

- Refrigerator sold for $2,000
- Includes 1-year assurance + 2-year extended coverage
- Total estimated cost: $300 ($100 assurance, $200 service)
- Fair value of service portion: $150

At Sale:

plaintext

Dr. Cash 2,000

Cr. Sales Revenue 1,850

Cr. Unearned Warranty Revenue 150

Assurance-Type Accrual:

plaintext

Dr. Warranty Expense 100

Cr. Warranty Liability 100

Service-Type Revenue Recognition (Year 1):

plaintext

Dr. Unearned Warranty Revenue 75

Cr. Warranty Revenue 75

5. 📊 Liability Roll-Forward Example

Component	Amount
Beginning Liability	$200,000
+ Accruals	$120,000
- Payments	($75,000)
+ Adjustments	$10,000
= Ending Liability	$255,000

6. 📋 Disclosure Requirements (ASC 460-10-50)

- Nature and terms of warranty
- Aggregate liability amount
- Roll-forward of liability
- Estimation methods

7. 🌎 IFRS Comparison (IAS 37)

Standard Treatment of Warranties

US GAAP Split between assurance and service-type

IFRS No formal split; provisions accrued if probable and measurable

8. ⚠️ CMA Exam Pitfalls to Avoid

- ❌ Using actual costs instead of estimated expense
- ❌ Accruing maximum in range without justification
- ❌ Confusing assurance-type with service-type
- ❌ Ignoring multi-year cost implications

9. 🧠 Strategic Study Tips

- Practice roll-forward tables and range estimates
- Use visual frameworks for multi-year scenarios
- Review ASC 450 for contingency parallels
- Focus on journal entries and timing of expense recognition
- Use Gleim/Wiley for scenario-based drills